# CIO Newsletter

TATA MUTUAL FUND

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## Market Outlook 2015-16

**The year that was**

Fiscal year 2015 has been important for India in more ways than one. While one of the important events was the government winning a majority mandate during the general elections in May 2014, the global fall in commodities prices was a god-send for the economy. India's high import bill reduced, thanks to the over 40% correction in global crude prices. In fact, prices of major commodities have reduced by 5-40% over the last year and are down nearly 20-70% from their ten-year peak. This is significantly positive for India since the country's net imports of commodities (crude oil, industrial commodities, coal, precious metals, etc.) were at US$178bn in FY14 (9.5% of GDP). A 10% average fall in prices of these commodities has the potential to halve the country's CAD. India's net oil import bill is estimated to fall from US$102bn in FY14 to US$85bn in FY15 and US$75bn in FY16. All these factors have led to global investors pouring over US$17bn in FY15.

In FY15, benchmark indices Nifty and Sensex gave returns of 26.7% and 24.9% respectively. However, it was the mid cap and small cap companies that outperformed; the BSE mid cap and BSE small cap indices were up 49.5% and 54%. This trend highlights the overall potential growth of Indian equities. Sectors like healthcare (up 71.4%), consumer durables (up 59.6%), capital goods (up 44%) and banking (up 43.2%) were the leaders in FY15. IT sector too returned about 30% over the year. FMCG, power and realty ended the year on a positive note, albeit underperforming the benchmark indices. Metals and Oil & Gas were the only sectors that gave a negative return.

2015 turned out to be one of the best years for the bond markets after a fairly disastrous previous year. While in FY14, the 10-year benchmark yields rose by 90bps due to higher inflation and a tight monetary policy, FY15 saw the yields dropping by over 100bps (1%). The key reasons for the sharp drop in yields were the improvement in the macro-economic fundamentals of the economy, especially the fall in inflation/inflationary expectations and the improving external position (lower CAD and stable Rupee). After maintaining a high interest rate stance for most of the year, RBI finally announced two successive rate cuts of 25bps each in January and March 2015 as a result of inflation finally coming under control. Retail inflation which averaged around 9.5% in FY14 came down substantially in FY15;average inflation in the first 6 months of FY15 was around 7.30% and in the last 5 months of the year, it shrunk to ~4.55%. The latest inflation rate in Feb-15 was 5.37%. With a loose monetary policy and massive stimulus in Europe and Japan, FIIs were one of the largest investors in Indian debt papers due to the high interest rate differential. FIIs invested over Rs1.66tn in FY15 against outflows of Rs280bn in the previous year.

**Current state of affairs**

While returns have been very attractive in FY15, there emerged a sense of caution in the last quarter with Nifty and Sensex gaining a marginal 2.5% and 1.7% respectively. From a valuation perspective, the market is trading at over 16 times its next year's expected earnings, which is above its long term average. The gap between valuations and earnings growth of quality stocks has widened. Quarterly result trends indicate that improvement in economic activity and earnings is still a while away. Weak volume growth in the cement and consumer staples sectors and increase in non-performing loans in the banking sector point to risks in the expected corporate earnings.

**Ritesh Jain**
*Chief Investment Officer*
Tata Asset Management Ltd
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But these concerns largely pertain to the short term. On the positive side, the parliamentary activity by the government has picked up. As per PRS Legislative Research data, productivity of the just concluded pre-recess budget session of the Parliament was the highest in five years. The number of bills passed in the year 2015 signifies improvement in functioning of parliament over the past ten years. Given the government's well known minority position in the upper house, this should comfort investors. Among the 8 bills that were passed, three have meaningful economic impact in the long-term: the Mining bill, the Coal bill (ends one of the three remaining central government monopolies) and the Insurance bill. Of the ones that couldn't be passed, the important ones were the GST Bill and the Land Acquisition amendment bill. In our view, these are likely to be the government's focus in the second part of the budget session.

**Outlook**

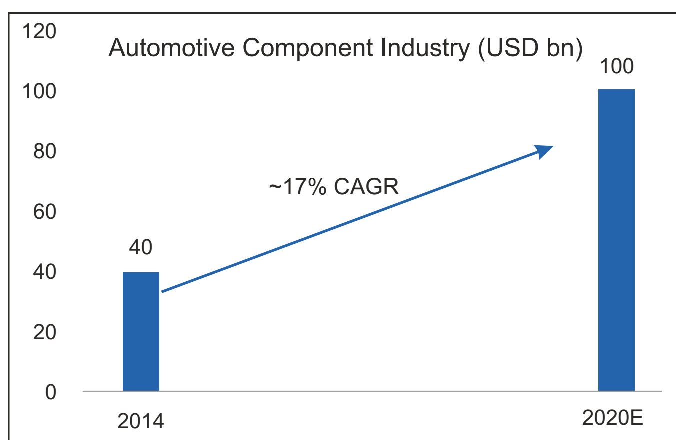
We continue to remain optimistic on Indian equities. Heading towards a revival in the overall economy, many sectors (excepting sectors linked with global commodities) are likely to benefit. Global liquidity remains comfortable and India, driven by political stability and lower commodity prices, is being viewed favourably by global investors, thereby providing valuation support. Markets would now reward earnings growth and a further increase in valuations would depend upon the improvement in earnings of the corporates. After a strong run up in FY15, prices of specific stocks and sectors are expected to move rather than the entire equity market.

The main risks to markets at this juncture seem global. The race to currency devaluation to boost exports could lead to some volatility in the financial markets. We would urge investors to invest systematically in the equity market and utilize the possible increase in volatility to their advantage.

On the debt market front too, we continue to remain positive. Though the yields have come down by over 100bps in FY15 and one may argue that much of the gains are already captured, we believe that there is still more room for yields to come down in FY16, may be by around 50-75bps. This is based on our expectation that inflation is likely to remain low at around 5.25-5.5%. This should give room for RBI to ease the policy rates further by around 25-50bps in FY16. However, if the consumer inflation rate rises again in FY16 (which looks unlikely at the moment) RBI may be unable to further reduce interest rates. In that eventuality, we expect the yields to remain range-bound at the current levels.

# Indian Automotive Component industry: On the cusp of growth

Going by Automotive Components Manufacturers Association's (ACMA - the industry body for component makers) estimates, the Indian auto ancillary industry seems to have hit a sweet spot. ACMA predicts that the industry would be worth US$100 bn by financial year 2020, a 17% compound rate of growth. But what makes them so bullish? After all, the industry, currently at US$40 bn, grew only at 9% CAGR (Compounded Annual Growth Rate) over the past six years.

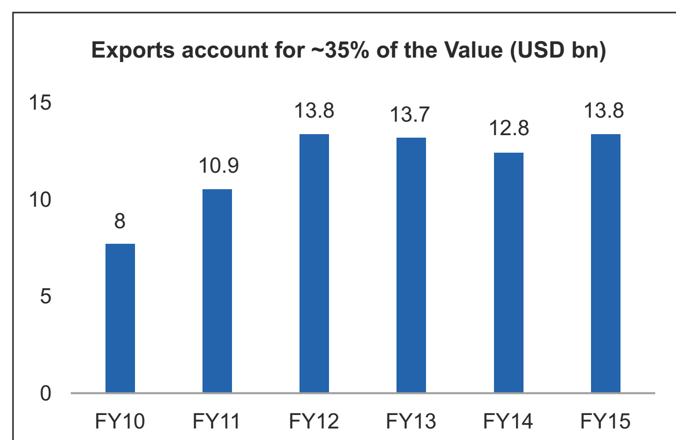



*Source: ACMA*

There are quite a few changes happening at the ground level which seem to be driving this sustained increase in the rate of growth. Let's look at the important reasons that will help achieve this objective.

**Exports – the backbone of the auto ancillary industry**

The auto component industry has borne the impact of weak demand from the domestic industry over the last few years. Growth in demand of commercial vehicles (trucks etc.) has been negative and car demand too has been low. Despite this, the industry has managed to grow at 9% CAGR in the past six years. This has largely been led by increasing export contribution to their income. As a result, the share of exports has gone up from 20% six years back to 35% of the industry presently. The industry players have slowly but surely consolidated their presence in the export markets and are now being acknowledged by global Original Equipment Manufacturers (OEMs) as dependable suppliers of auto components. The depth of the relationship with their foreign customers has been continuously increasing. Apart from usual peripheral components, Indian players are now supplying a range of critical engine parts apart from transmission, suspension and braking system components. Moreover, global auto component giants continue to enhance their investments in India via their subsidiaries.




*Source: ACMA*

**Domestic demand outlook improving**

The current year has already shown signs of slight recovery in categories like passenger cars. There is also improvement in the mood of the commercial vehicles sector as industrial activity starts picking up and mining issues get sorted out. In our view, a few positive trends are emerging in the Indian auto component space, which are likely to improve the prospects of the organized players. These are:

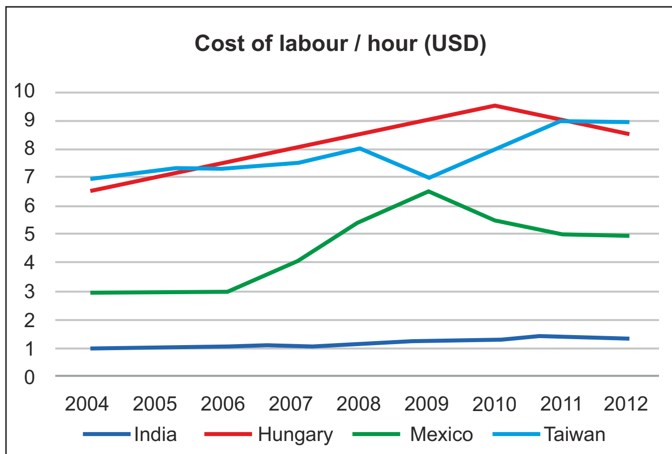
a) OEMs' drive to consolidate the number of vendors: Most Indian OEMs are reducing their supplier base and sourcing more parts from lesser number of suppliers (in line with global trends), thereby improving the business potential of the organized auto ancillary companies;

b) Changes in emission and safety norms - with Government focusing on ensuring safety (airbags and Anti-lock Braking System likely to become mandatory);

c) Use of more electronics - this trend is fast catching up with luxury car features now being made available even in affordable cars e.g. voice recognition system.

**India labour 'cost competitive'**

Compensation for skilled/unskilled labour in the organized manufacturing sector is lower in India as against other major manufacturing hubs like Mexico, Taiwan, Hungary, China, Philippines, etc. The contribution of exports has been increasing every year for most companies on the back of relatively better margins, thanks to lower overheads and labour costs in India.




*Source: ACMA*

**'Make in India' campaign - a booster dose for exporters**

With the 'Make in India' campaign, both domestic industries and the global players are set to benefit in the longer run. In addition to the natural advantages like cheaper and easily accessible labour in India, other favourable factors like improving infrastructure set-up, easier land acquisition process and minimization of policy related delays and constraints at the government level would give a leg-up to Indian manufacturing. Global players would find it attractive to make India a manufacturing hub to cater to nearby markets, just as they have done with China and Thailand. It is likely to be a win-win situation for both the manufacturers and the government as it would help create more jobs and add to the tax kitty, along with better profitability for the manufacturers.

**In conclusion**

Though auto component companies' revenues have grown at a low rate over the past couple of years, they have improved Return on Capital Employed due to improving profit margins. With capex needs being very minimal, they have been generating robust free cash flows (FCF) and reduction of borrowings in their balance sheets. This has led to a lowering of their interest costs and stronger earnings growth. This is unlikely to change much over the next couple of years. **For a large part of the industry, there exists ample scope to improve capacity utilization and cater to growth over the next couple of years. Effectively, future growth will need limited capex and this would result in strong FCF generation and profitability.**

# Meet our Fund Manager

**Atul Bhole,**
*Senior Fund Manager*

**Question: You manage Tata Midcap Growth Fund. How would you describe this fund? How do you think it is different from other midcap funds or midcap management strategies?**

**Answer:** Our strategy is to select fundamentally sound companies which are run by quality management and which can sustain growth momentum. We are ready to buy and hold such companies even if they are trading at a slightly higher valuation. We don't venture into identifying and betting on turnaround or asset-play stories beyond a point. All our efforts are directed towards identifying companies with secular growth stories which benefit from the compounding growth of their earnings. While picking stocks, we remain focused on those companies that exhibit growth, free cash flows and a sensible cash allocation policy from the company's management. Despite focus on stock selection, the fund remains invested in 50-60 stocks across sectors, with the top 5 and top 10 stocks constituting only 16-17% and 29-30% of the portfolio respectively. This helps lower the concentration risk and provides better risk-adjusted returns.

**Question: Midcap stocks are relatively less researched. How much do you and your analysts rely on third party research in midcap stocks? How much of your investment calls are backed by in-house research?**

**Answer:** We have a reasonably well-experienced team of 10 members in the equity investment function with specialization in certain sectors, both individually as well as through small teams. The ideas are generated from various sources like sell side research, peer holdings, in-house teams looking at market opportunities in sectors / sub-sectors, general reading, etc. However, for all our holdings and new investment ideas, especially midcaps, we follow a well-defined process which involves screening companies on various business, operational and financial parameters apart from management interaction, financial projections and valuation comparison. For midcap companies, taking a call on management quality and integrity is important, which we try to do by looking at history as well as the recent trends in performance and behaviour of the management.

**Question: What is the investment universe for midcap stocks of Tata AMC? What factors are considered for inclusion/exclusion of a stock in the midcap universe?**

**Answer:** We do not have a separate midcap universe. The total investment universe of Tata AMC is about 450 companies of which, roughly 325 are midcap companies. The most important factor to be checked for inclusion of a midcap company in our universe is the management quality and integrity. This is a subjective call which we take by looking at the history as well as recent trends in performance and behaviour of the management. This is followed by an assessment of the sector's opportunity and attractiveness, entry barriers, leadership positions, margin defence of the sector, capital intensity, etc. Next on our checklist is how the company has grown, its free cash flows and capital allocation policy. And finally, technical factors like valuations and liquidity are assessed before a stock is included in our universe.

**Question: Midcap investing is all about bottom-up stock selection. Do you factor macro research into your investment strategy? If yes, how do you do it?**

**Answer:** Macro research definitely acts as a starting point. Looking at macro trends, one can deliberate over the areas or sectors of the economy that would benefit from these

trends. This is followed by looking for companies that would benefit from the expected continuation of the trend or turnaround in the macro environment. Also at the macro level, technical factors like standalone and relative market valuations, flows from FIIs and DIIs, liquidity in the markets, etc. have to be considered while choosing the right investments for the portfolio. In other words, though each company is bought and sold on its merit, one has to keep in mind the macro factors too.

**Question: Being a midcap fund, corporate governance plays an important role in stock selection. What factors do you consider in this regard?**

**Answer:** As already mentioned, judging corporate governance is a subjective call. Bad corporate governance is not just about siphoning money from the business through unscrupulous ways or about unlawful ways of doing business; it also extends to the use of capital. Past decisions of the management in terms of capital allocation is one of the most important factors to watch out for. Imprudent capital allocation decisions like venturing outside the core area of the company, audacious capex or thoughtless acquisitions are some of the red flags of corporate governance. No / limited cash conversion for longer time periods and consistently lower return on equity than cost of capital are few other fallouts of poor corporate governance.

**Question: Midcap funds tend to do well during bullish times and vice versa. Do you change your investment strategy and approach according to market cycles?**

**Answer:** Our strategy is to select fundamentally sound companies that are run by quality management and which are able to sustain their growth momentum. We believe in staying invested in such companies and benefit from the compounding of their earnings. Based on market outlook and macro parameters like absolute and relative valuations, liquidity and fund flows, we may change the fund focus slightly. However, the core holdings and strategy remain largely the same over both the bull and bear cycles. We have observed that secular growth companies tend to outperform over the long-term and that too with limited volatility even though in a fierce bull market, such companies may underperform for a limited time period.

**Question: How do you manage market volatility? Do you use cash exposure and if so, to what extent? Do you instead prefer derivatives for hedging?**

**Answer:** Market volatility is best managed by proper diversification and buying a good quality set of companies. We don't take aggressive cash calls. Rather, if we are absolutely convinced about an impending market move, we may hedge the portfolio or specific sector exposures through call or put options. In option hedging, one knows the downside right at the beginning. We typically buy longer dated options to prevent faster time decay. Such hedging is done very rarely and depends on an expected or unexpected outcome of a significant event in the offing.

**Question: Compared to large caps, what is the average premium/discount in valuation of midcaps historically? How is the situation at present?**

**Answer:** Historically, midcaps have tended to trade at around 20% discount to large caps. At present, that discount is completely absent. However, we think this may not be the right way to look at the scenario. Large caps are predominantly represented by commodities or banking companies whose P/E ratio is structurally on the lower side compared to sectors with secular earnings growth. On the other hand, many midcap companies which operate in smaller sectors have a niche brand and leadership position in their respective sectors and hence, have a huge opportunity ahead of them. Such companies also possess a high potential of compounding their earnings, better capital allocation, cash conversion, return ratios, etc. So they deserve to trade at a higher valuation at which they are presently trading. One should not get worried by just looking at valuation multiples.

**Question: Give us your views about markets. How is the midcap space looking over the next 3 years?**

**Answer:** Our view on the market is still constructive despite valuations reaching historical averages. We believe earnings from many sectors would catch up as the broader economy recovers and interest rates head further south. We believe midcaps would still outperform the large caps over the next 3 years. However, I would like to split the market into two sets – the good quality, high growth companies and the not-so-good companies with problems like low growth and / or unmanageable debt levels. The first set would definitely outperform despite their valuation premium being higher to start with.

## Dashboard

| Index Name | Returns (%) | | | | | P/E | P/B | Dividend Yield |
|---|---|---|---|---|---|---|---|---|
| | 1 M | 6 M | 1 Yr | 3 Yr | 5 Yr | | | |
| **Broad Market Indices** | | | | | | | | |
| S&P BSE Sensex | -4.8 | 5.0 | 24.9 | 17.1 | 9.8 | 18.7 | 2.9 | 1.3 |
| NSE CNX Nifty | -4.6 | 6.6 | 26.7 | 17.0 | 10.1 | 22.7 | 3.7 | 1.3 |
| NSE CNX 500 | -3.6 | 8.8 | 33.6 | 18.2 | 10.1 | 24.3 | 3.2 | 1.3 |
| S&P BSE 100 | -4.3 | 7.4 | 28.3 | 17.4 | 9.8 | 18.8 | 2.7 | 1.2 |
| **Thematic Indices** | | | | | | | | |
| CNX Infrastructure | -1.7 | 7.6 | 24.3 | 9.0 | -1.0 | 20.7 | 2.3 | 1.1 |
| CNX Consumption | -0.7 | 5.1 | 28.3 | 21.3 | 16.3 | 32.7 | 5.3 | 1.0 |
| CNX MNC | -1.6 | 16.0 | 52.9 | 23.3 | 15.7 | 68.9 | 7.4 | 0.9 |
| CNX 500 Shariah Index | -0.8 | 6.2 | 32.2 | 19.6 | 11.0 | 23.4 | 3.8 | 0.9 |
| CNX PSE | -4.8 | -1.4 | 21.7 | 6.1 | -1.7 | 12.3 | 2.0 | 3.5 |
| CPSE Index | -4.8 | -3.5 | 19.8 | 7.9 | 4.0 | 12.9 | 2.4 | 4.0 |
| **Strategy Indices** | | | | | | | | |
| CNX Alpha | 3.7 | 21.9 | 71.9 | 31.9 | 20.7 | 27.7 | 4.5 | 1.8 |
| CNX Dividend Opp | -5.6 | -1.3 | 17.8 | 9.3 | 10.7 | 13.4 | 2.1 | 3.1 |
| CNX High Beta | -7.4 | 5.4 | 24.9 | 2.1 | -6.6 | 14.2 | 0.9 | 1.5 |
| CNX Low Volatility | -0.8 | 13.7 | 45.2 | 22.0 | 15.4 | 25.4 | 4.7 | 1.3 |
| **Sectoral Indices** | | | | | | | | |
| CNX Auto | -3.5 | 9.1 | 48.6 | 27.0 | 21.9 | 54.2 | 6.8 | 0.8 |
| CNX Bank | -7.5 | 18.3 | 42.9 | 21.2 | 14.0 | 19.0 | 2.9 | 1.0 |
| CNX Pharma | 8.9 | 18.4 | 68.3 | 36.6 | 26.2 | 52.9 | 8.9 | 0.5 |
| CNX FMCG | -5.8 | 0.0 | 9.9 | 20.3 | 22.3 | 46.3 | 13.2 | 1.4 |
| CNX IT | -4.6 | 6.9 | 30.0 | 22.8 | 15.6 | 21.8 | 6.8 | 1.2 |
| CNX Realty | -9.7 | 6.6 | 14.3 | -3.3 | -12.8 | 29.3 | 1.1 | 0.9 |
| **Fixed Income Indices** | | | | | | | | |
| CRISIL MIP Blended Index | -1.6 | 15.6 | 16.4 | 10.6 | 8.6 | NA | NA | NA |
| Gsec 10-Year NSE | 7.4 | 19.4 | 14.0 | 7.6 | 6.0 | NA | NA | NA |
| NSE Treasury Bill Index | 8.4 | 8.5 | 8.3 | 8.5 | 7.7 | NA | NA | NA |
| **Alternative Assets** | | | | | | | | |
| Gold* | -1.2 | -2.0 | -8.3 | -2.2 | 10.0 | NA | NA | NA |

*Non-annualised for 1M & 6M, CAGR for 3Y & 5Y

**Returns from housing real estate**

| City | 1 year CAGR (%) | 2 year CAGR (%) | 3 year CAGR (%) | 7 year CAGR (%) |
|---|---|---|---|---|
| Mumbai | 5% | 9% | 9% | 13% |
| Delhi | -3% | 6% | 9% | 10% |
| Bengaluru | 0% | 4% | 5% | 1% |
| Hyderabad | 13% | 6% | 1% | -1% |
| Kolkata | 12% | 4% | 3% | 11% |
| Chennai | 17% | 7% | 13% | 20% |
| Pune | 10% | 10% | 17% | 13% |

*Source: NHB Residex*

NHB Residex is a residential housing price index covering 26 cities of India starting 2007. The index is owned by National Housing Bank, India's apex level institution for housing. The study incorporates actual transaction prices to arrive at the index values. NHB Residex is considered a reliable proxy for housing real estate price trends in India. The following observations are noted:

- Delhi is driven by expansion in NCR which has supplied land for development. Besides, a lot of black money chases real estate in Delhi which keeps the prices high
- Mumbai is driven by supply constraint – both natural (geographic) and synthetic (artificial supply choked by developers) factors influence the real estate market in Mumbai
- Hyderabad has suffered due to the state bifurcation issue and a lot of real estate investment is moving to the newly created state and especially to the coastal city of Vishakapatnam

# TATA MID CAP GROWTH FUND

(An Open-ended Equity Scheme)

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## Bat for the future. Invest in growth today.

**This product is suitable for investors who are seeking*:**

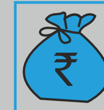
- Long Term Capital Appreciation.
- Investment predominantly in equity & equity related instruments of growth oriented mid cap companies.
- The scheme is classified as **High Risk** ■ **(BROWN)**. Investors understand that their principal will be at high risk.

*** Investors should consult their financial advisors if in doubt about whether the product is suitable for them.**

**Note:** Risk may be represented as:

**(BROWN)** investors understand that their principal will be at high risk.

**(YELLOW)** investors understand that their principal will be at medium risk.




**(BLUE)** investors understand that their principal will be at low risk.

**Contact Your Financial Advisor**

**Mutual Fund investments are subject to market risks, read all scheme related documents carefully.**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